Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Benoit | Analyst: Jeff Garnier | Bill Number: AB 1490

Related Bills: See Legislative History | Telephone: 845-5322 | Introduced Date: February 21, 2003

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Withholding on Sale of California Real Estate Not Required if Seller's Residence

SUMMARY

This bill would exempt from the $3^{1/3}$% real estate sales withholding requirement the sale of a residence of a taxpayer.

PURPOSE OF THE BILL

The author's staff has indicated the purpose of the bill is to clarify that the withholding on the sale of California real property enacted by the Legislature last year does not apply to a taxpayer's personal residence.

EFFECTIVE/OPERATIVE DATE

This provision is effective January 1, 2004, and would apply to sales of real property on or after January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of that interest in real property. The withholding obligation is generally imposed on the buyer or the withholding agent, either of whom must report the amounts withheld and pay them to the Internal Revenue Service.

Under state law, when California real estate is sold, buyers are required to withhold 3 ⅓% of the total sales price if certain conditions are met.

Generally, the buyer is required to withhold when purchasing California real property where the seller is:

- An individual or a trust.
- A corporation that has no permanent place of business in California immediately after the sale of the real property.

Board Position:			Department Director	Date
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For individual sellers, withholding is not required if any of the following are met:

1. The total sales price of the California real property is $100,000 or less.
2. The buyer did not receive written notification of the withholding requirements.
3. A corporate mortgagee or a beneficiary under a deed of trust is acquiring the property in foreclosure.
4. The seller certifies under penalty of perjury that:
   - The property conveyed was the seller's principal residence within the meaning of Internal Revenue Code (IRC) Section 121 (a principal residence that the individual has lived in two out of the five years before the sale),
   - The property is being exchanged under the like-kind exchange provisions of IRC Section 1031,
   - The property was involuntarily converted or sold as defined under IRC Section 1033, or
   - The sale results in a loss to the seller.
5. The amount of withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

<u>THIS BILL</u>

This bill would exempt from the $3^{1/3}$% real estate sales withholding requirement the sale of a residence of a taxpayer, regardless of whether the residence is the taxpayer's principal residence under IRC Section 121. Thus, sales of real property would be exempt from withholding if the seller lived in the property for any period so long as the property continued to be a residence of the taxpayer. For example, a vacation home could qualify under this change as a residence of a taxpayer. The taxpayer would certify, under penalty of perjury, the home sold was a residence of the taxpayer.

LEGISLATIVE HISTORY

AB 2065 (Oropeza, Stats. 2002, Ch. 488) expanded the real estate withholding provisions to residents and converted the waiver process for individuals into a certification process.

AB 1338 (Chavez, 2003) would:
- Modify the real estate withholding provisions to permit withholding of 9.3% of the gain on the transaction in lieu of $3^{1/3}$% of the sales price,
- Require withholding on the portion of any gain from the sale of a principal residence that is not excluded from taxable income,
- Revise the withholding requirements on certain corporations to match the requirements applicable to individuals,
- Make the real estate escrow person (REEP) jointly and severally liable for real estate withholding and remove a provision that prohibits a penalty being assessed on the REEP for failure to properly withhold if the seller reports the gain on the sale of the property and pays the proper amount of tax, and
- Clarify that certain non-taxable transfers of real property are not subject to withholding.

AB 1338 is presently at the Assembly Desk.

AB 628 (Runner, 2003) would eliminate real estate withholding on the seller if:

- the individual selling the property is a sole proprietor that constructs and sells residential houses, and
- the real property is treated as inventory for personal income tax purposes in the hands of the seller, whether the residence qualifies as the seller's residence or not.

This bill is presently at the Assembly Desk.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to California's present real estate withholding law or proposed by this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs and operations.

ECONOMIC IMPACT

Tax Cash-Flow Estimate**:**

This bill would result in Cash-flow losses as follows:

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Estimated Cash-Flow* Impact of AB 1490 As Introduced February 21, 2003 Effective for tax years BOA 1/1/2004 Enacted after 6/30/2003 $ Millions		
2003-04	2004-05	2005-06
-$1	Minor loss*	Minor loss*

* Below $250,000.

Cash-flow Estimate Discussion

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

The cash-flow impact of this bill was derived as follows. First, the sales of the residences that do not meet the two-year live-in requirement of a principal residence in 2000 were estimated using the department's personal income tax sample. Next, the sales of second and vacation homes were estimated. These sales amounts are extrapolated to 2004 based on the projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified sales. This gross amount is adjusted downward for the qualifying amount, fiscal year differences, offsetting estimate/withholding payments under current law, and other prepayments.

This cash-flow loss is largely a one-time event. The term "cash-flow" gain or loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law payments will be affected.

LEGISLATIVE STAFF CONTACT

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